# Office of Chief Counsel Internal Revenue Service

### memorandum

CC:NER:BRK:TL-N-94-00

REGole

date: MAY 0 1 2000

to: Chief Examination Division, Brooklyn District

Attn: Robert Browne (E:E:F:1203)

from: Acting District Counsel, Brooklyn

subject:

EIN:

This is in further response to your request for advice regarding whether combined compensation in the form of stock grants of \$ and \$ to two high level executives of the taxpayer is reasonable under I.R.C. § 162. Under routine Counsel procedures, we forwarded this case to our National Office for their review of the conclusions rendered in our memorandum dated April 13, 2000.

#### DISCLOSURE STATEMENT

This advice constitutes return information subject to I.R.C. § 6103. This advice contains confidential information subject to attorney-client and deliberative process privileges and if prepared in contemplation of litigation, subject to the attorney work product privilege. Accordingly, the Examination or Appeals recipient of this document may provide it only to those persons whose official tax administration duties with respect to this case require such disclosure. In no event may this document be provided to Examination, Appeals, or other persons beyond those specifically indicated in this statement. This advice may not be disclosed to taxpayers or their representatives.

This advice is not binding on Examination or Appeals and is not a final case determination. Such advice is advisory and does not resolve Service position on an issue or provide the basis for closing a case. The determination of the Service in the case is to be made through the exercise of the independent judgment of the office with jurisdiction over the case.

We are enclosing a copy of the Informal Field Assistance dated April 27, 2000 which was drafted by the National Office. The memorandum indicates that the National Office generally concurs with the conclusions reached by our office. However, the National Office suggests that further coordination of issues related to the timing of the compensation deductions under I.R.C. §§ 83, 403, 421 and/or 422 may be necessary. We do not believe further coordination is necessary based on our understanding of the facts. If upon your further review of this case, you believe that there may be an issue as to the timing of the claimed deductions, please contact our office so that we can assist you in the further development of such issues.

Any questions regarding this opinion should be referred to Rose Gole at (516) 688-1702. We are closing our file at this time.

JODY TANCER Acting District Counsel

Bv:

ROSE E. GOLE

Attorney

Attachment: As stated.

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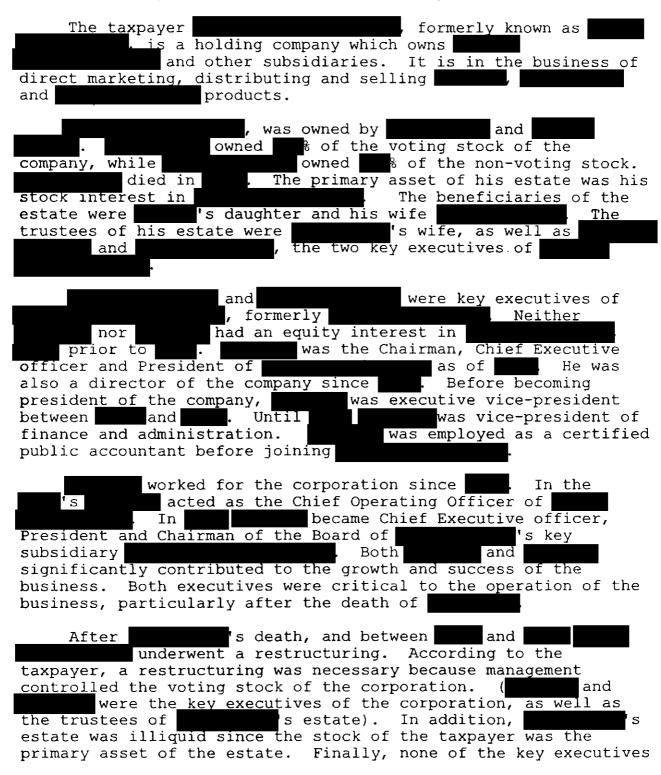
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#### **FACTS**

The facts, as we understand them to be, are as follows:



or employees of the taxpayer had an equity interest in the corporation.

The taxpayer a taxpayer operated					The
bus: the distribution bu	iness was wo:	rth \$	in co	mparison	to
and liabilities of	and the distribute the Distribute The bute the Distribute the Dist	ution busine siness was r rganized int	ss was tra enamed	the a nsferred	to
Under the auspoperations improved taxpayer expanded between and in to \$ of approximately markets increased to \$ international mark follows tax consequences of the follows.	d. According its business Net sa in Second in	g to its fin , domestical les increase , a compo ales in the he same peri ). The taxp from \$  in d pany also gr ants and cas	ly and int d from \$ unded annu an od. (\$ ayer's sal to  ividends f anted	tement, ernation al incread es in the \$ for its and	the ally, ase in e
		·			
	Grant	Grant	Grant	Gi	cant
Value of Stock Grant	\$	\$	\$	\$	
Tax Gross-up	\$	\$	\$	\$	
Total	\$	\$	\$	\$	
Total Combined Grant	\$		\$		

The shares would be forfeited if the taxpayer could not

adequately restructure equity sale acceptable did not participate in Board of Directors of	e to the family the dividends. A the taxpayers set asic	Resolution of the de additional stock
for purchase by other 's further allude to a St not have any informati management of	consolidated financia cock Option plan. How	l statements for ever, our office does
In \$ . The taxp on .	purchased of of payer completed an ini-	
discounting the the terms of the grant	ons. For example, atil the end of the terms of fering. The grant is grant is grant. It is grant in grant annual installing annual installing grayer.  Standard a valuation study of the stock contains and applying a grant is grant in grant	restricted until rant vested years nt vested the day of vested in e sale to ments. The stock or and years
Grant	\$	\$
Grant	\$	\$
Total	\$	\$
The student paid to and of compensation grants		75 <sup>th</sup> -90 <sup>th</sup> percentile

paid to and fell within the 75<sup>th</sup> -90<sup>th</sup> percentile of compensation grants to chief executive officers of public corporations in its database. The study states: "We would conclude from these analyses that the stock grants (valued in a manner consistent with our LTI ["Long Term Incentive"] survey methodology), are in line with competitive LTI practices, albeit within the upper quartile (i.e., above the 75<sup>th</sup> percentile) of the competitive practice distribution."
Without the vesting discount stock compensation exceeded the

90<sup>th</sup> percentile and second 's compensation fell within the 88<sup>th</sup> percentile of the included companies.

Revenue Agent Browne also produced information showing the salary and bonuses of several comparable companies. The salary and bonuses for the relevant period range from approximately annually. Revenue Agent Browne also provided excerpts of Value Line for the included companies. Several of the chief executive officers of the comparable companies received stock options as part of their compensation packages. Our office does not have sufficient information to determine the value of the stock option grants.

Since and were both the executors of the estate and the officers of the taxpayer, they were concerned about the potential penalties for self dealing. According to a memorandum received advised by Counsel not to take pay raises, pay themselves bonuses out of the ordinary course of business, or provide themselves equity incentives without the approval of all parties interested in the taxpayer and sessions sessions.

In addition, since aspects of the company's restructuring, including the stock compensation grants were approved by the shareholder-beneficiaries of sestate as well as the Surrogate Court. "Approval documents" executed by all interested parties were also obtained for all management decisions. The taxpayer has provided copies of the resolutions of approving the compensation grants.

The terms of the stock grants are also memorialized in the Compromise Agreement filed with Surrogate's Court proceeding, In re: File no. Paragraph of the Compromise Agreement states:

and agree that the respective provisions hereof for each of them provide adequate compensation for their having acted as Executors and Trustees and having performed other services herein referred to and they agree that they have acted as such and rendered such services for such compensation, which will be their sole compensation, and they acknowledge their waiver of any and all such statutory fees and commissions to which they may be entitled by reason of their acting as (1) the Executors and the Trustees, (2) as trustees of the trusts under will and (3) as trustees of the Trust.

#### DISCUSSION

Code section 162(a)(1) allows a deduction for:

ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered.

"The test of deductibility in the case of compensation payments is whether they are reasonable and are in fact payments purely for services." Treas. Reg. § 1.162-7(a). The taxpayer therefore must establish two elements. First the payments must be reasonable, and second, the payment must be for services actually rendered.

#### a. The Stock Option Compensation is Reasonable.

Generally, our research suggests that there is very little case authority for disallowing paid compensation where the employees are unrelated to the employer. This is because there is no motivation on the part of shareholders to disguise salary as dividends. See Exacto Spring Corporation v. Commissioner, 196 F.3d 833, (7th Cir. 1999), rev'g T.C. Memo. 1998-220, citing, Mayson Manufacturing Co. v. Commissioner, 178 F.2d at 119-120 ("It is more unlikely that [two shareholders] would have approved a substantial 'disguised dividend' to [the majority shareholder] where they did not receive a substantial dividend or some other benefit as well. When there is no close relationship between the share of compensation and the share of stock holdings, it may be a persuasive indication that the company is receiving compensable services and that profits are not being siphoned out of the company disguised as salary.")

and were not shareholders of The fact that the taxpayer weighs heavily in favor of the conclusion that the stock grants were for compensable services. In addition, 's compensation was approved by the family-member shareholders of , as well as all the interested parties in the Surrogate's proceeding pertaining to 's estate. Furthermore, and went to great lengths to avoid the appearance that they were self-dealing. Therefore, they did not award themselves excess bonuses during the period of the taxpayer's restructuring. were separately represented from the and shareholder-beneficiaries in the Surrogate's Proceeding.

Moreover, in large publicly held corporations, the deductibility of compensation is infrequently challenged because

the corporation is usually dealing at arm's length with its employees. Owensby & Kritikos, Inc. v. Commissioner, 819 F.2d at 1322. Although the taxpayer did not have a public offering until 1994, this case is more akin to that of a public corporation because 1) the executives were not shareholders and 2) the stock compensation grants were made in connection with the sale and public offering of the taxpayer's stock. Therefore, we think the Tax Court would not look favorably upon the disallowance of the executive compensation.

While the amounts of the stock option grants to and and are very large, (\$ for and \$ and \$

Generally speaking, if contingent compensation is paid pursuant to a free bargain between the employer and the individual made before the services are rendered, not influenced by any consideration on the part of the employer other than that of securing on fair and advantageous terms the services of the individual, it should be allowed as a deduction even though in the actual working out of the contract it may prove greater than the amount which would ordinarily be paid.

Treas. Reg. § 1.162-7(b)(2). Consequently, the stock option compensation may be proper even though it was more valuable and resulted in a higher amount than would ordinarily have been paid if negotiated as a straight salary package. The executives bore the risk associated with the price of the option. In this instance, the stock option grants to and had such a high value because of the sale of a partial interest in the taxpayer to stock.

There is no bright line test for determining the reasonableness of employee compensation, but rather, the Courts look to a number of factors, including the following:

- 1) The employee's role in the taxpaying company, including the employee's position, hours worked, and duties performed;
- 2) potential conflicts of interest such as the ability to "disquise" dividends as salary;
- 3) the employer's compensation policy for all employees;
- 4) the character and financial condition of the company; and

5) comparison of the employee's salary with those paid by similar companies for similar services.

Rapco. Inc. v. Commissioner, 85 F. 3d 950, 954 (2d Cir. 1996), aff'g. T.C. Memo. 1995-128, citing, Elliotts, Inc. v. Commissioner, 716 F. 2d 1241, 1245-1248 (9th Cir. 1983); Normandie Metal Fabricators, Inc. v. Commissioner, T.C. Memo. 2000-102; Mayson Manufacturing Co v. Commissioner, 178 F. 2d 115, 119 (6th Cir. 1949).

No single factor is determinative and the taxpayer bears the burden of proof. <u>Pacific Grains, Inc. Commissioner</u>, 399 F.2d 603, 606 (9th Cir. 1968); T.C. Rule 142. No single factor controls. Furthermore, the factors should be analyzed from the perspective of an independent investor. <u>Dexsil Corp. v. Commissioner</u>, 147 F. 3d 96, 100 (2d Cir. 1998), <u>vacating and remanding</u>, T.C. Memo. 1995-135. Many of the factors favor allowing the deduction in this case.

## 1) The employee's role in the taxpaying company, including the employee's position, hours worked, and duties performed

The contribution of the executive to the success of the company is a significant factor in determining the reasonableness of compensation. Elliotts, Inc. 716 F.2d at 1245-1246; Lumber City Corp. v. Commissioner, T.C. Memo 1996 -171. This factor is highly weighted towards the taxpayer since it is very likely that in this case a Court would attribute the success of to its key executives, and Both executives were critical to the running of the taxpayer's business, particularly since when passed away. was even an officer of the taxpayer, while the corporation's founder, was alive. The high regard for 's contribution to the management of the and taxpayer is also demonstrated by the fact that the late appointed the officers as executors of his estate. also contributed to the taxpayer's and significant growth. The taxpayer represents that its financial statements demonstrate that between and total equity increased by more than the per year, and the annual return on equity was in excess of the %. The taxpayer's net sales, particularly in the international market grew significantly. Net sales doubled in the year period between and Ιt is probable that a Court would conclude that an independent

<sup>&</sup>lt;sup>1</sup>It is reasonable to consider the period because of the restrictions on the stock option compensation.

investor would be willing to highly compensate the executives of a corporation showing such high sales growth. This factor favors the taxpayer.

### 2) Potential conflicts of interest such as the ability to "disquise" dividends as salary.

There is no possibility that the compensation paid by the taxpayer was intended as a disguised dividend. The officers had no equity interest in the corporation until the option grant in On the contrary, the shareholders of did in fact receive dividends of \$ \_\_\_\_\_\_. The officers did not share in the distribution of the dividends.

In addition, the likelihood of any potential conflict of interest is mitigated by the fact that the third party shareholders and beneficiaries of sestate expressly approved the compensation award, as did the Surrogate's Court. Finally, because of their fiduciary responsibilities, went to substantial lengths to avid the appearance of self-dealing. Therefore, this factor also favors the taxpayer.

#### 3) The employer's compensation policy for all employees.

We do not have significant information regarding the compensation paid to other executives of the taxpayer. However, the certified financial statements and minutes of the Board of Directors of the taxpayer suggest that the taxpayer did implement a program for issuing stock options to its other managers. It is likely that the award to other managers would not be comparable in magnitude to the stock option grants to

The taxpayer argues, in an undated memorandum to the Service, that it is impossible to compare the compensation to and to that of any other employee of the taxpayer. Curtis, Inc. v. Commissioner, T.C. Memo. 1994-15. While this may be correct, our office has insufficient facts to evaluate this factor.

#### 4) The character and financial condition of the company.

This factor also favors the taxpayer. The taxpayer was undergoing substantial growth during the years through when the options were granted, and thereafter. The taxpayer's net sales, increased dramatically. Its return on equity was increasing at a favorable annual rate. Finally, the taxpayer's business was growing.

In addition, the company was undergoing a substantial restructuring of both its operations and its ownership. The taxpayer sold a structuring in the process of structuring an initial public offering and the taxpayer was in the midst of spinning off its less successful distribution business. A Court would likely conclude that it was reasonable to award the company's key executives stock option compensation so that they could share in the Company's growth.

## 5) Comparison of the employee's salary with those paid by similar companies for similar services.

The taxpayer produced a study comparing the stock option grant with that paid to other executives. The study concludes that the stock option grants are at the high range, albeit within the range, of the amount typically paid to high level executives included n their sample. The stock option compensation fell within the 75th-90th percentile of the range for long term incentive compensation, as discounted by 3% annually to account for vesting restrictions. Without a discount factor, so compensation fell within the 88th percentile and so so compensation exceeded the 90th percentile compensation. We believe the results of the study leave open the possibility that a Court might be willing to adjust so study leave open the study leave open the possibility that a Court might be

However, the taxpayer may argue that to the extent, if any, that the stock option compensation exceeds the range paid to comparable executives, the excess is intended to compensate for past services. Deductions for prior services may be compensated in a later year. Lucas v. Ox Fibre Brush Co., 281 U.S. 115 The taxpayer must, however, establish that there was not sufficient compensation in the prior periods and that in fact the current year's compensation was to compensate for that underpayment. Estate of Wallace v. Commissioner, 95 T.C. 525 (1990); Modernage Developers, Inc. v. Commissioner, T.C. Memo. 1993-591; Nelson Brothers, Inc. v. Commissioner, T.C. Memo. 1992and may be able to demonstrate that they were under-compensated in the past. First, they can demonstrate that they received no increase in compensation between the award of the stock compensation in \_\_\_\_\_ Therefore, the officers can demonstrate that their compensation did not increase after the death of , at which time their responsibilities increased. Second, executives in comparable positions typically receive deferred compensation in the form of stock options. In this case, and nev<u>er re</u>ceived any equity in the taxpayer until the option grant in

The Service engineer also produced a memorandum comparing 's and 's compensation with salary and bonuses paid to executives of companies identified by the taxpayer as comparable. The engineer's comparison does not take into consideration deferred compensation. According to the Value Line summaries attached to the engineer's memorandum, the executives of many of the included companies received deferred compensation. Since the amount of the deferred compensation is not included in the income comparisons, we do not think the Service engineer's results are reliable. Owensby & Kritikos, T.C. Memo. 1985-267 (Expert criticized for not expressly allocating option compensation in his comparison).

Case authority sustains the disallowance of compensation where the taxpayer failed to demonstrate that the payments were for services actually rendered. Payments made as an inducement to continue employment by definition are not for services "actually rendered." The Tax Court has disallowed compensation paid in the form of stock paid as an inducement for retaining future employment services. Crasto v. Commissioner, T.C. Memo. 1956-37; Nelson Brothers, Inc. v. Commissioner, T.C. Memo. 1992-726 (One factor in disallowing compensation paid to an officer was evidence that the compensation was intended as payments for services to be performed in the future.) Therefore, there is authority for disallowing the deduction to the extent that the payment is intended as an inducement to continue employment.

### b. <u>A Portion of the Compensation May Not Be for Services</u> Rendered.

Case authority sustains the disallowance of compensation where the taxpayer failed to demonstrate that the payments were for services actually rendered. Payments made as an inducement to continue employment by definition are not for services "actually rendered." The Tax Court has disallowed compensation paid in the form of stock paid as an inducement for retaining future employment services. Crasto v. Commissioner, T.C. Memo. 1956-37; Nelson Brothers, Inc. v. Commissioner, T.C. Memo. 1992-726 (One factor in disallowing compensation paid to an officer was evidence that the compensation was intended as payments for services to be performed in the future.) Therefore, there is authority for disallowing the deduction to the extent that the payment is intended as an inducement. The taxpayer acknowledges that the stock options and their restrictions were intended as an inducement for and and to continue their employment with the taxpayer. Therefore, the Service can argue that a portion of the compensation is not for services rendered.

In addition, the Compromise Agreement filed with the Surrogate's Court indicates that and waived their executors fees. To the extent that a portion of the stock compensation is also intended as payment for and services as executors of the state, a portion of the deduction claimed by the taxpayer could be disallowed.

While there is justification for disallowing a portion of the compensation on the grounds that it is not for services rendered, we believe the overwhelming share of compensation is reasonable.

#### CONCLUSION

Each of the five factors typically considered by the Tax Court and the Second Circuit either favor the taxpayer or are neutral. In addition, Courts are unlikely to challenge compensation paid to non-shareholders. In this case there is an additional check placed on the reasonableness of the compensation since the Surrogate's Court and the beneficiaries of estate approved the compensation. Therefore, we would not recommend disallowing the Compensation as "unreasonable." However, we believe that the Service has a reasonable argument that a portion of the compensation is not for services rendered. Arguably a portion of the compensation was paid 1) in lieu of awarding and executor's fees and 2) for as an incentive to continue their employment with the taxpayer rather than for services rendered. Such expenses would not be proper under I.R.C. § 162.

You have advised us that the taxpayer has proposed a settlement highly favorable to the Company. We believe the proposed settlement has merit in light of our preliminary analysis. We recommend that you continue your settlement discussions with the taxpayer taking into consideration this legal analysis.

You should be aware that, under routine procedures which have been established for opinions of this type, we have referred this opinion to the National Office for review. That review might result in modifications of the conclusions herein. We will inform you of the result of the review as soon as we hear from the National Office. In the meantime, the conclusions reached in this opinion should be considered to be only preliminary. Therefore, we request that you contact our office before relying on the conclusions, set forth above.

Any questions regarding this opinion should be referred to Rose Gole at (516) 688-1702.

JODY TANCER Acting District Counsel

By:

ROSE E. GOLE Attorney